



*August 2009*

Dear ,

This issue of the WKBK&Y newsletter addresses:

1. IRS Extends FBAR Filing Date for Certain Individuals
2. Tax Accrual Workpapers Held Not Protected by Work-Product Privilege
3. Tax Treatment of Gifts and Sales of Interests in Single-Member LLCs

**1. IRS Extends FBAR Filing Date for Certain Individuals**

*Introduction*

In our June 2009 newsletter we discussed Treasury Form TD F 90-22.1, Report of Foreign Bank and Financial Accounts (FBAR), and specifically we focused on an amnesty program being offered by the IRS. The amnesty program allows taxpayers, who do not have unreported offshore income, to avoid potential penalties by filing delinquent FBARs no later than September 23, 2009. Please see our June 2009 newsletter for more information regarding the amnesty program.

Recently, the IRS issued Notice 2009-62, which extends the FBAR filing date for certain individuals.

*Background*

The FBAR requirement was put in place to help combat overseas tax evasion. However, it was not until the IRS was delegated the responsibility of enforcing the FBAR in 2003 that enforcement of the FBAR began to have teeth. The penalty for a willful violation of the FBAR is the higher of \$100,000 or 50% of the balance in the account at the time the violation occurred; while non-willful violations can be as high as \$10,000 per violation. In addition, a criminal violation of the FBAR may result in up to 5 years in prison plus a fine.

*Notice 2009-62*

In regard to FBARs related to 2008 or earlier years, Notice 2009-62 extends the FBAR due date through June 30, 2010 for the following individuals:

- (i) persons with signature authority over, but no financial interest in, a foreign financial account; and
- (ii) persons with a financial interest in, or signature authority over, a foreign commingled fund

In addition, it is important to remember that taxpayers, who do not fall within one of the above classifications and do not have unreported offshore income, will still have until September 23, 2009 to file past FBARs as we discussed in our June 2009 newsletter.

#### *Request for Public Comments*

The IRS is still trying to figure out best practices in regard to many aspects of FBAR reporting and, in this regard, has solicited public comments in connection with the following areas:

- (i) when a person with signature authority over, but no financial interest in, a foreign financial account should be relieved of filing an FBAR for the account;
- (ii) the circumstances in which the exception from FBAR filing currently available for officers and employees of banks and certain publicly-traded domestic companies should be expanded to apply to all officers and employees with only signature authority over, and no financial interest in, an employer's, or client of the employer, foreign financial account;
- (iii) when an interest in a foreign entity (e.g., a corporation, partnership, trust, or estate) should be subject to FBAR reporting; and
- (iv) whether a U.S. person should be relieved from an FBAR filing requirement with respect to a foreign commingled fund in other circumstances, such as when filing would be duplicative of other reporting?

#### *WKBKY Takeaway*

The IRS in 2009 has either issued amnesty programs or extended deadlines for many taxpayers with FBAR reporting requirements, providing taxpayers with several different options to become compliant with past FBAR reporting requirements. To take advantage of the IRS's various offers, tax practitioners should consult with clients as soon as possible. Compliance with the FBAR reporting requirement is easy to do and can avoid costly penalties. Taxpayers who do not have unreported offshore income, but did not file FBARs in past years should take advantage of the IRS's amnesty offer and file delinquent FBARs by September 23, 2009.

## **2. Tax Accrual Workpapers Held Not Protected by Work-Product Privilege**

### *Introduction*

The First Circuit has recently reversed itself, holding that a public company's "tax accrual workpapers" were not protected by the work-product privilege.

In our February 2009 newsletter we reported the First Circuit's decision in *United States v. Textron, Inc.*, 553 F.3d 513 (2009) ("*Textron I*"), which held that a public company's tax accrual workpapers, which list questionable tax positions taken on a tax return, estimate the likelihood of success of such positions, and calculate the amount of additional tax liability that would result from the revisions of those positions, are protected from IRS discovery under the work-product privilege.

The First Circuit met en banc and reversed (3-2) *Textron I*. (*United States v. Textron, Inc.*, 2009 U.S. App. LEXIS 18103 (2009) ("*Textron II*").)

### *Work-Product Privilege*

The work-product privilege protects from discovery "documents and tangible things that are prepared in anticipation of litigation or for trial by or for another party or its representative." (Fed. R. Civ. P. 26(b)(3)(A).) The First Circuit uses the "because of" test. Under this test, a document is protected "if, in light of the nature of the document and the factual situation in the particular case, the document can be fairly said to have been prepared or obtained because of the prospect of litigation." (*Maine v. US Dept. of Interior*, 298 F.3d 60, 70 (1st Cir. 2002).) But the "because of" standard does not protect from disclosure documents that are prepared in the ordinary course of business or that would have been created in essentially similar form irrespective of the litigation. (*Id.*) The term "litigation" in this context is construed broadly and includes anticipation of IRS audit disputes. (*US v. Roxworthy*, 457 F.3d 590, 600-01 (6th Cir. 2006).)

### *Facts*

The taxpayer, Textron, Inc. ("Textron"), is a publicly traded corporation. Federal securities laws require publicly traded companies to obtain a letter from an independent auditor approving the company's financial statements, including an analysis by the auditor as to whether the company has reserved an appropriate amount to cover potential losses. Accordingly, Textron prepared tax accrual workpapers to substantiate Textron's anticipated likelihood of success on its tax positions and to establish to the auditor that it was adequately reserved with respect to any potential disputes or litigations that would happen in the future. Textron's attorneys analyzed each potentially questionable tax position and estimated a percentage of success if challenged by the IRS. The reserve was calculated by multiplying this percentage by the tax benefit claimed.

Textron identified the likelihood of success as 0% for a number of issues in cases where a subsequent legal development rendered a prior position indefensible. Textron anticipated it would concede these issues on audit.

Ernst & Young (“E&Y”) was Textron’s auditor. E&Y was permitted to look at Textron’s tax accrual workpapers but was not permitted to retain a copy of them.

The IRS subpoenaed Textron’s tax accrual workpapers, and Textron asserted work-product privilege barred IRS discovery of the workpapers. The IRS also subpoenaed E&Y’s audit workpapers.

### *Analysis*

The First Circuit found that the workpapers were not protected by the work product privilege and commented that Textron in essence had a legal obligation to prepare the workpapers to comply with securities laws and accounting principles, which in turn allowed Textron to issue certified financial statements. Based on such reasoning, the First Circuit rejected the District Court’s reasoning that the work product privilege should apply to the workpapers since the reserve would not have been necessary “but for” the possibility of litigation.

The First Circuit reiterated its opinion in *Maine* that the work product privilege does not apply to “documents that are prepared in the ordinary course of business or that would have been created in essentially similar form irrespective of the litigation” and further noted that “[t]he privilege is aimed centrally at protecting the litigation process, [citation], specifically, work done by counsel to help him or her in litigating a case. It is not a privilege designed to help the lawyer prepare corporate documents or other materials prepared in the ordinary course of business. Where the rationale for a rule stops, so ordinarily does the rule.” (*Textron II* at 24-28.)

One of the pillars of the work product privilege is the idea that the lack of such privilege would discourage sound preparation for a lawsuit since opposing counsel would be able to access the documents prepared for litigation. The First Circuit opined that in Textron’s case this concern does not exist since exchange-listed companies already have a duty to prepare such workpapers. The First Circuit went on to note that if litigation did arise, there is no evidence that the workpapers would serve a useful purpose in the litigation.

Finally, the First Circuit focused on the importance of revenue collection and noted that a number of unusual tools are furnished to the IRS to assist in the collection of revenues.

### *Dissenting Opinion*

The dissent argued that the majority had silently overturned its own precedent, the “because of” test, in an effort to assist the IRS, and further argued that the majority not only construed the privilege narrower than the “widely rejected” Fifth Circuit test but also misconstrued the privilege which does not require that work-product be created to aid in the litigation.

## *WKBKY Takeaway*

*Textron II* puts taxpayers on notice that mental impressions regarding the viability of a particular reporting position may be discovered by the IRS where workpapers are prepared for reasons other than (or in addition to) impending adversarial proceedings.

At the same time *Textron II* is a very particular situation, and the breadth of the decision (how it would apply in to other situations) remains to be seen. In addition, the close decision *en banc* may suggest that the issue is ripe for Supreme Court review. Moreover, *Textron II* is only binding in the First Circuit. While Circuits employing the “because of” test may cite to *Textron II* in holdings, other Circuits have different tests for the work product privilege. That each of these tests is aimed at the same policy suggests that the conclusion would be the same no matter which Circuit a taxpayer resides in, but that is by no means certain. In any event, the closeness of this decision (and its back-and-forth nature) suggests that *Textron II* may just be the starting point for future litigation.

### **3. Tax Treatment of Gifts and Sales of Interests in Single Member LLC**

#### *Introduction*

On August 24, 2009, the Tax Court issued *Pierre v. Commissioner*, 133 TC No. 2 (2009), holding that a single-member LLC (“SMLLC”) was not disregarded for purposes of a donor making a gift of interests in the LLC. The IRS argued that the Petitioner could not gift interests in the LLC since the LLC was disregarded for Federal tax purposes, positing that the transfer was instead a deemed transfer of the LLC’s assets. At the heart of the dispute were valuation discounts; if characterized as a transfer of the LLC’s assets, valuation discounts would not have been available to the taxpayer.

#### *Discounts Due to a Lack of Marketability and Control*

Code section 2501 imposes a tax on transfers of property by gift. Generally, the value of the property at the time of gifting is the value used for purposes of calculating the gift tax. “The value of the property is the price at which such property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or to sell, and both having reasonable knowledge of relevant facts.” (Regs. § 25.2512-1.) Valuation discounts are often applied to gifts of minority interests in LLCs since the minority interests are less marketable and do not give the donor control over the entity, and, therefore, would result is a lower price from a willing buyer.

#### *Facts*

The Taxpayer in *Pierre* owned a SMLLC and gifted a 9.5% interest in the LLC to two trusts he had created for his children’s benefit. Per an independent appraisal, the taxpayer applied a 30% discount to the value of the non-managing interests in the LLC due to a lack of marketability and control. The IRS decided that the Petitioner’s transfers should be

characterized as a transfer of the underlying assets of the LLC and not a transfer of LLC interests since the LLC was a disregarded entity. The IRS assessed issued a deficiency notice against the Petitioner.

### *Analysis*

The Tax Court rejected the IRS's contention that the check-the-box regulations also controlled for gift tax purposes. The Tax Court continued that the IRS's position would result in federal law rather than state law defining property rights and would be incompatible with the Supreme Court's interpretation of federal estate and gift tax statutes. The Court also noted that Congress has enacted laws to specifically address perceived abuses in the valuation rules and has chosen to eliminate valuation discounts for LLCs (neither generally nor to SMLLCs in particular).

### *WKBKY Takeaway*

Indeed, *Pierre* is a sound result and one that is quite beneficial to taxpayers. But *Pierre* does more than give practitioners security in dealing with transfers of SMLLC interests. It reaffirms that the income and transfer tax provisions of the Code work independently.

This principle is something that an estate planner should always have in mind. For example, many practitioners utilize the disconnect between the grantor trust and the estate and gift tax statutes as a means of maintaining a donor's ownership (for income tax purposes) of trust assets while freezing the value of the assets for estate and gift tax purposes. Conversely, practitioners who do not wish to create a grantor trust should be weary of creating rights (such as a *Crummey* withdrawal right) that, while they may not trigger gift tax consequences (by utilizing the 5 and 5 language in the gift and estate tax statutes), may create a grantor trust for income tax purposes.

*We hope that you find these items of interest to you. If you need further information or would like to discuss a particular issue, feel free to call any one of the lawyers listed below. We will get you to the right person.*

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